



The new regulatory architecture

THE CHANGING ROLE OF THE FSA

This briefing looks at the global, EU and domestic reforms of the regulatory architecture proposed as a result of the financial crisis and the changing role of the Financial Services Authority and its approach to supervision of firms.

Introduction

The initiatives for regulatory reform to respond to the financial crisis are set to have significant implications for the Financial Services Authority (FSA). Global and EU initiatives are raising issues relevant to the FSA's autonomy in rule-making and supervisory approach. Against this international background, at a UK domestic level, the FSA's relationship with the firms it supervises is set to change in consequence of its new 'systemic and intrusive' approach to supervision. This briefing highlights the main developments and their implications.

International aspects

Global finance without global government

Global banking institutions are global in life and national in death, as the Governor of the Bank of England has pointed out. In life, these groups operate freely on a global basis, but their collapse is an essentially national process. Although they are subject to a patchwork of often very different national regulatory and supervisory regimes, the reality is that host states are often highly dependent on home states' regulatory systems and supervisory decisions over which they have little control. The risks of such reliance crystallise when a firm fails, and the costs of bail-outs are national.

In the immediate aftermath of the collapse of Lehman Brothers in September 2008 there was considerable political support for much greater 'supra-national' or 'global' regulatory harmonisation. There was, however, no consensus on whether the establishment of a global

body with binding decision-making powers was the appropriate response. Since that time there has been widespread recognition, notably at the G20 London summit in April 2009 (the London G20), that a regulator with direct supervisory and enforcement powers that transcend national borders is not, as yet, a viable model. Ultimately the effects of supervisory decisions can have fiscal cost to a national government and a 'global' model would lack the requisite political accountability for that cost. As such, the principal responsibility for UK regulatory rule-making and direct supervision of, and enforcement against, UK firms looks set to remain with the FSA.

Supervisory colleges

The London G20 advanced the further development of international supervisory colleges of regulators as the best method of co-ordinating international regulatory oversight for cross-border financial institutions. A deadline of June 2009 was set to complete the creation of colleges, building on the 28 already in place. The core role of the colleges will be to share information, particularly in respect of the location of risk within a financial group. It remains to be seen what practical differences the colleges will make to the approach of national supervisors. While the FSA and other supervisors will clearly be required to place a greater importance on colleges, and sharing of information will be enhanced, without a common rulebook and without power to supervise beyond national boundaries colleges are not, in the FSA's own admission, a 'universal panacea' to the problems of cross-border supervision.

Crisis management

In times of financial crisis the need for international co-ordination and efficient flows of information becomes particularly acute. However, it is in times of crisis when there is a tendency for supervisors to focus most on national concerns. There is, as yet, no clear international consensus on the legal framework for crisis management arrangements for cross-border institutions. While the UK has developed significant national measures to provide a legal framework for crisis resolution (such as the Banking Act 2009 and related legislation) there is no cross-border legal framework for a failing institution. The basic problem is the question of burden-sharing – how should costs be split between the countries involved, and what implications does that have for countries' influence in decision-making? Even if this could be resolved, technical differences in national company, insolvency and administration law and procedure would make a coherent cross-border legal framework extremely difficult on a European, let alone international, level. In April 2009 the Financial Stability Forum (FSF) published a set of high-level principles for cross-border co-operation on crisis management, which the London G20 committed to implement immediately. The principles recommend the core supervisory college of a cross-border institution should meet at least annually to consider crisis management issues and barriers to co-ordinated action.

International oversight

While the direct supervision of financial institutions looks set to remain a national responsibility, the London G20 agreed that the augmented FSF, now renamed as the Financial Stability Board (FSB), should be given an enhanced role with the International Monetary Fund (IMF) in international oversight of financial stability. Although the FSB will clearly be a thought leader as to the shape and content of the emerging international regulatory architecture it should certainly not be thought of as a global supervisory authority. Even in respect of its systemic responsibilities (such as the operation of supervisory colleges, development of crisis management arrangements and conducting 'early-warning' exercises to identify the build-up of macroeconomic and financial risks) the FSB will not be given a rule-making mandate or powers to intervene in the actions of G20 national authorities.

European aspects

The problems revealed by the crisis

There is a high degree of consensus within Europe that the financial crisis has exposed significant weaknesses in the regulatory architecture for regulation and supervision at European level. As a result, an independent group under the chairmanship of Jacques de Larosière was tasked by the European Commission with making proposals on how to strengthen European co-operation on financial stability and how best to organise the supervision of European financial institutions (among other things). The group produced its report in January 2009 and its main recommendations are being taken forward in the proposals referred to below.

One major deficiency identified by the de Larosière group has been the lack of a formal structure or mechanism for monitoring and ensuring the stability of the financial system as a whole – so-called 'macro-prudential' supervision. This gap is now to be filled by the creation of a European Systemic Risk Board (see below).

The other big issue that de Larosière considered is the structure for regulating and supervising particular financial institutions. In essence the problem is that European legislation has enabled banks to do business freely across borders within the EU by means of the 'passporting' system, while at the same time failing to ensure a sufficiently high degree of harmonisation of regulatory and supervisory practice at member state level. The result has been that 'host' state governments (and ultimately taxpayers) have had to meet the costs of the failure of banks based elsewhere in the European Economic Area (EEA), whose supervision has been entirely beyond host state control and may be perceived as inadequate (at least with the benefit of hindsight).

The collapse of the Icelandic banks in 2008 brought the problem home to a wider audience, in particular the UK authorities. It is largely this experience that has caused the FSA's Chairman, Lord Turner, to state that the current passporting system is 'untenable'. He sees the solution as either 'more Europe' (ie greater harmonisation), 'less Europe' (ie some cutting back on passporting rights), or both. The response at EU level has largely been to opt for 'more Europe'.

The European Systemic Risk Board (ESRB)

The de Larosière group's recommendation to establish a European Systemic Risk Board was taken up by the European Commission in a communication it published in May 2009. It was endorsed with minor modifications by the European Council at the Economic and Financial Affairs Council (ECOFIN) meeting in June 2009. The main elements of the proposal, as approved by the Council are as follows.

The ESRB's role will be to monitor and assess threats to financial stability in the EU, to identify and prioritise such risks and to issue warnings, where appropriate, to policymakers and supervisors. The ESRB will also have power, where necessary, to make recommendations on the measures to be taken to respond to the identified risks. ESRB recommendations may be general, or may concern individual member states. Recommendations will be non-binding, but the expectation is that they will carry substantial weight and that a 'comply or explain' regime would apply. The ESRB will be composed of the President of the European Central Bank, the governors of the 27 national central banks, the chairmen of the three European Supervisory Authorities (see below) and a member of the European Commission.

The European System of Financial Supervisors (ESFS)

The European Commission and the Council have also endorsed the de Larosière group proposal for a European System of Financial Supervisors. The aim of the ESFS will be threefold: to upgrade the quality of supervision at national level, with far stronger and consistent powers for supervisory and sanctioning regimes; to strengthen oversight of cross-border groups by completing the establishment of supervisory colleges for all major cross-border firms in the EU by the end of 2009; and to move towards a single rulebook for all EU financial institutions, removing key differences in national legislation.

The ESFS will be composed of the existing 'Level 3 Committees' re-formed with legal personality under European law and increased powers. They will also be renamed as the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority (together, the European Supervisory Authorities or 'ESAs'). Interestingly, the FSA had advocated the idea of a single European regulatory body as part of a 'more Europe' approach to resolving the problem of cross-border institutions.

The new powers and responsibilities to be given to the ESAs include:

- power to develop binding harmonised technical standards (subject to endorsement by the Commission);
- power to make recommendations addressed to a national supervisor to correct a manifest divergence from binding EU requirements;
- (where a college of supervisors cannot reach agreement) power to settle the matter by binding decision;
- power to adopt emergency decisions (eg in relation to short-selling) in a crisis; and
- responsibility for authorisation and supervision of some specific entities with pan-European reach (eg credit rating agencies and EU central counterparty clearing houses).

The UK government has been keen to ensure that supervisory decisions concerning particular financial institutions should remain the exclusive preserve of national supervisors, so as to retain domestic political accountability in view of the potential fiscal costs of these decisions. In consequence, the May 2009 ECOFIN meeting concluded that many of the ESAs' new powers and responsibilities should be framed in terms that ensure that they do not impinge on members states' fiscal responsibilities.

Supervisory colleges within the EU

The role of colleges of supervisors within the EU has been formalised and extended as a result of recent changes made to the Capital Requirements Directive. These colleges will now be obliged to include host state supervisors not just of financial sector subsidiaries, but also of branches of financial institutions that are systemically important in the host state. Guidance on the functioning of these colleges, and a template for an agreement between relevant supervisors, has been published by the Committee of European Banking Supervisors (CEBS).

UK domestic aspects

A major shift in the FSA's approach

The financial crisis has forced the FSA to rethink its regulatory philosophy. Historically its approach had been

based on the assumption that markets are self-correcting and that the primary responsibility for risk-management lies with firms' own management. The FSA's focus had been primarily on the health of particular institutions rather than on the financial system as a whole, and its supervision of particular firms looked more at the adequacy of systems and processes rather than on the firm's business models and strategy. In vetting a firm's management appointments the FSA had considered probity but not competence. Overall, the FSA's approach concentrated more on conduct of business issues than prudential regulation.

The change began in April 2008 in the aftermath of the Northern Rock debacle, when the FSA set up a 'Supervisory Enhancement Programme' to improve the quality of its supervision. The Turner Review in March 2009 indicated an intention to take this approach further, with a regime that is 'more intrusive and more systemic'. There is to be a significant increase in FSA resources dedicated to high-impact firms. The FSA's assessment of firms will place less emphasis on systems and processes and more on business outcomes and risks and the sustainability of business models. The FSA will consider technical skills when vetting management appointments. It will conduct more sectoral and comparator analysis when assessing firms' risks, and invest in building up specialist skills (eg in liquidity analysis). There will be a new focus on risks resulting from remuneration structures. The FSA will concentrate more on macro-prudential issues as well as sectoral analysis. There will also be a major shift in the FSA's role in relation to accounting issues, with the FSA having a much more intensive engagement with firms in this area.

The architecture of the UK regulatory system

The respective roles of the various bodies involved in the UK regulatory system have come under scrutiny during the crisis. The Bank of England's role in ensuring financial stability has now been put on a formal statutory footing in the Banking Act 2009. The new 'special resolution regime' for dealing with failing banks (now enacted in the Banking Act 2009) gives 'gatekeeper' powers to the FSA, but it is the Bank of England that determines which particular resolution tool is to be used.

Opposition parties and parliamentary committees have pointed to weaknesses in the overarching tripartite structure of UK financial supervision, which divides

responsibilities between the FSA, the Bank of England and the Treasury. Some have called for the return of banking supervision to the Bank of England. But it now seems clear that the present government has no intention of making major changes of that kind.

However, there is still an ongoing debate on whether additional powers should be given to the Bank of England to enable it to perform its financial stability role – ie tools to prevent the size, leverage, fragility and risk of the financial system from becoming too great. The Bank has been pressing strongly the case for it to be given the necessary powers to do the job. At present it can only give warnings and the Governor has pointed out that warnings are unlikely to be enough to change behaviour that appears at the time to be highly profitable.

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